cover sheet and agenda

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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 5/1/84 **Number:** 168981CA **Due By:**

Subject: Cabinet Council on Economic Affairs - May 3, 1984 - 8:45 a.m.

Roosevelt Room TOPICS: Financial Condition of Utilities
Federal Credit Policy

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
Baker	☑	☐
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, May 3, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background papers are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson
☑ Tom Gibson
Associate Director
Office of Cabinet Affairs

☐ Don Clarey
☐ Larry Herbolsheimer

L-300B

THE WHITE HOUSE

WASHINGTON

May 1, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the May 3 Meeting

The agenda and papers for the May 3 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider two agenda items. The first is a report from the Working Group on the Financial Condition of Utilities. At the Council's April 17 meeting questions were raised as to what would happen in the event of one or more bankruptcies of electric utilities involved in nuclear plants. The Working Group has considered this issue and prepared an interim report on the possible consequences which is attached.

The second agenda item is a report from the Working Group on Federal Credit Policy. The specific issue concerns the expansion of the secondary market for SBA-guaranteed loans. A paper on this issue is also attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

May 3, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on the Financial Condition of Utilities (CM # 468)

2. Report of the Working Group on the Federal Credit Policy (CM # 113)

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

CM 468

May 1, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Working Group on the Financial Condition of Utilities

SUBJECT: Interim Report on the Possible Consequences of Bankruptcy of Utilities Involved in the Construction of Nuclear Plants

At the meeting of the CCEA on April 17, questions were raised as to what would happen in the event of one or more bankruptcies of electric utilities involved in nuclear plants. While preparing this response to these questions, it became obvious that the significant involvement of the Rural Electrification Administration (REA) in loan guarantees to rural electric cooperatives for the financing of potentially troubled nuclear plants presents issues that will require a near-term Administration decision.

Possible Federal Liability Due To REA Exposure

The REA has guaranteed all of the borrowings of the rural electric cooperatives that are involved in financing shares of the costs of construction of numerous nuclear power plants. Many of these plants face the prospect of cancellation or continued cost escalation, which could expose the Federal government to substantial obligations under the guarantees if the cooperatives were to be unable to support their debt obligations.

As of April 30, the REA was committed to guarantee $9.7 billion of debt incurred by cooperatives for the construction of nuclear plants (15 cooperatives are involved in 17 projects) currently under construction. Of this amount, $6.1 billion has already been advanced. (See Attachment A for a list of REA commitments and advances of guarantees, outstanding and pending.) The distinction between advanced guarantees and commitments to issue guarantees may be significant in cases of bankruptcy because only commitments actually advanced appear to be reachable by a bankruptcy trustee.

For example, at Marble Hill, which has been cancelled, REA has advanced guarantees of $479 million out of the $950 million committed. Guarantees have been issued to two REA cooperatives involved in the Seabrook project in a total amount of $86 million out of $219 million committed.

Pressures are mounting for REA to decide whether (a) further advances and (b) new REA guarantee commitments should be made. Certain rural cooperatives have already been asked to increase their shares of plants where cotenants have discontinued their shares of the financing. Significant requests by rural cooperatives for additional advances and commitments of guarantees on these projects are pending. The requests for additional commitments of guarantees amount to $450 million as of today. Further advances of guarantees have also been requested. It is expected that the two cooperatives participating in Seabrook will request advances of guarantees of about $800,000 of borrowings in the next 30 days.

In light of these considerations, REA clearly is a party to the decisions on the future of these projects. There is a distinct possibility that any action taken by REA may be viewed as a precedent for a Federal response to pleas for assistance from investor-owned and municipal utilities involved in troubled nuclear projects.

Accordingly, it is especially important that, in its analysis of whether to approve guarantee advances or further commitments, REA address a broad range of issues. These include whether a given nuclear plant should be completed, converted to fossil fuel, or written-off. The objective is clearly to ensure that "good money is not thrown after bad."

The Administrator of REA has the power under the loan guarantee contracts to refuse additional loan guarantees if the borrower cooperative cannot demonstrate the economic and engineering feasibility of the project. On the other hand, the Administrator of REA has the authority, as long as certain requirements are satisfied by the borrower, to provide additional guarantees of financing needed to complete the project even if the borrower's share of the costs escalates.

REA also has the authority to implement a variety of financing options that may be perceived as "bail-out" or subsidy actions. For example, REA could permit defaults on guaranteed loans; defer principal and/or interest payments; authorize alternative depreciation methods; or condition advances of additional funds on third party buy-outs of indebtedness, with or without tax or regulatory assistance.

Furthermore, legislation is pending before the Congress that, while not directly related to nuclear plants, has provisions that would allow forgiveness of REA debt, subsidize borrowing costs, or subordinate the priority of the REA-guaranteed debt.

Important decisions on nuclear-plant financing are imminent. This week, the Justice and Agriculture departments will be meeting on the general issue of the government's position in bankruptcy and default situations. Both the Seabrook and Marble Hill projects are facing serious financing problems. Absent the development of ac-

ceptable financing alternatives, bankruptcies or defaults may occur within 60 days.

Consequences of a Utility Bankruptcy

With respect to a utility bankruptcy, two fundamental points should be noted. First the utility will continue to operate and supply its customers with power and, in the short term at least, the utility's cash position should be improved. (See Attachment B for a cash-flow analysis of selected utilities.) Second, a utility bankruptcy will present substantial and novel legal questions. These questions make it impossible to predict the ultimate outcome of any utility bankruptcy. Attachment C reviews these legal questions in more detail.

In the event of a bankruptcy, electricity would continue to be provided to the utility's customers. In the short term, after seeking bankruptcy protection, the utility will continue to operate and produce electricity with few, if any, discernable effects. Utilities have a stockpile of both fuel and supplies and, for the first 20 days after a filing for bankruptcy, utilities that are members of a power pool will continue to receive power (on the same terms) as before the filing. Thus bankruptcy should not produce any immediate change in the utility's operations.

In addition, as a result of halting costly construction and suspending payments of dividends (common and preferred) and interest (secured and unsecured), the filing utility's cash flow should be significantly improved. While each case can be expected to be different, it is likely in the short term that this improved cash-flow position would enable the utility to meet the requirements of suppliers for cash payments (or bonds) and the costs of bankruptcy itself.

In the long term, however, a utility bankruptcy presents complex legal questions for which there are no ready answers. The following are the types of questions that are likely to arise.

(1) The most complicated question in a utility bankruptcy would be the required interaction and coordination of the Bankruptcy Court and the State public service commission(s). For a reorganization plan to be confirmed, the regulatory commission(s) with jurisdiction over the rates of the debtor utility would have to approve any rate change provided for in the plan. On the other hand, the Bankruptcy Count would have to determine that the proposed plan was feasible. Thus the Court could impute a rate structure to determine that a plan was feasible, and the State commission could refuse to set rates at the level imputed by the Court. The Court could then find that the rates permitted by the public service commission were too low to permit a finding that the plan was feasible. Due to this overlap, there would be a real poten-

tial for a stalemate between the Bankruptcy Court and the State regulatory commission.

(2) What would be the long-term effects of a bankruptcy on a utility's ability to continue to deliver reliable service and complete and operate nuclear power plants? In this regard, there are questions concerning retention of key employees and performance of needed maintenance and construction.

(3) How would a bankruptcy affect a utility's capital structure? Two features of outstanding secured debt (first mortgage bonds) likely would be litigated. These questions are (a) whether the lien would extend to accounts receivable and revenues, and (2) whether penalty interest provisions (raising the interest rate on all outstanding bonds to the highest interest rate on any bond) would be applied. Additional questions are whether, and under what terms, utilities in bankruptcy could raise significant amounts of new capital.

(4) A utility bankruptcy would present a number of novel Nuclear Regulatory Commission (NRC) questions since construction and operation of nuclear power plants are subject to NRC control and license. The two most significant questions are: (a) whether a utility in bankruptcy would be able to keep its NRC permits and licenses, and (b) under what terms and conditions a bankrupt utility can sell its interest in a partially completed plant. With respect to an operating nuclear power plant, factors relating to bankruptcy (i.e. loss of key personnel or ability to perform maintenance) could raise health and safety issues that could prompt NRC action. In addition, dismissal of current management or appointment of a trustee could be viewed as a change of ownership requiring NRC approval. With respect to selling a partially completed plant, the buyer would be required to obtain a new NRC construction permit, and that process could be expected to take some time.

(5) A bankruptcy would raise questions concerning a utility's ability to obtain and retain nuclear insurance and to use insurance proceeds.

(6) The rights of cotenants in a nuclear power plant (either under construction or in operation) would be jeopardized if another cotenant were to file a bankruptcy petition. In addition, in a utility bankruptcy, equity investors and unsecured creditors would face the loss of most, if not all, of their money.

(7) In addition to possible Chapter 7 or 11 filings by investor-owned utilities, municipal utilities that are parti-

cipants with the investor-owned utility in a nuclear power plant may also be required to file for bankruptcy under Chapter 9 of the Bankruptcy Code. Chapter 9 proceedings are subject to somewhat different treatment.

The above list is, by necessity, incomplete. A utility bankruptcy is almost certain to present questions not currently anticipated.

Thomas J. Healey
Assistant Secretary
(Domestic Finance)

Attachments

ATTACHMENT A

INVOLVEMENT OF THE RURAL ELECTRIFICATION ADMINISTRATION
IN THE FINANCING OF NUCLEAR PLANTS UNDER CONSTRUCTION
(dollar amounts in millions)

Nuclear Unit & Location	Plant Capacity (MW)	Share of REA Cooperatives	REA Loans or Loan Guarantees			
			To Date		Pending	
			Commitments	Advances	Commitments	Advances
	(1)	(2)	(3)	(4)	(5)	(6)
Totals	19,148	16.96%	$9,747.2	$6,109.2	$450.0	--
Millstone 3 (Conn.)	1,159	.35	13.3	7.1		
Vogtle (Georgia)			2,394.7	1,136.0		
Unit 1	1,150	30.00				
Unit 2	1,150	30.00				
Clinton 1 (Illinois)	950	20.00	614.9	565.0	280.0	--
Marble Hill (Indiana)			949.6	479.0		
Unit 1	1,130	17.00				
Unit 2	1,130	17.00				
Wolf Creek 1 (Kansas)	1,150	6.00	229.0	157.8		
River Bend 1 (La.)	934	30.00	1,396.7	846.4		
Enrico Fermi 2 (Mich.)	1,100	20.00	619.7	619.7	170.0	--
Grand Gulf (Miss.)			400.0	385.0		
Unit 1	1,250	10.00				
Unit 2	1,250	10.00				
Seabrook (N.H.)			219.1	85.9		
Unit 1	1,150	2.58				
Unit 2	1,150	2.58				
Susquehanna 2 (Pa.)	1,050	10.00	578.4	424.3		
Comanche Peak (Texas)			310.1	244.8		
Unit 1	1,150	5.97				
Unit 2	1,150	5.97				
Catawba 1 (S.C.)	1,145	75.00	2,021.7	1,158.2		

Source: U. S. Department of Agriculture.

U.S. Department of the Treasury
Office of State & Local Finance
May 1, 1984

ATTACHMENT B

CASH FLOW ANALYSIS OF SELECTED UTILITIES FOR THE YEAR ENDED 12/31/83[a]
(dollars in thousands)

Company	Consumers Power Company (1)	Long Island Lighting Company (2)	Public Service Company of Indiana, Inc. (3)	Public Service Company of New Hampshire (4)
Latest Financial Report Dated	12/31/83	12/31/83	12/31/83	12/31/83
Pre-Tax Interest Coverage[b] (excluding AFUDC*)	1.35x	1.64x	1.99x	1.21x
Pre-Tax Interest Coverage[c] (including AFUDC)	1.65x	2.54x	2.85x	2.34x
Cash Flow Interest Coverage[d]	1.69x	1.98x	2.47x	1.51x
Determination of Cash Flow				
Net Income	$347,764	$364,974	$255,847	$151,658
Non-cash Items:				
Depreciation	186,641	63,415	82,314	21,016
Deferred Income Tax	(4,569)	65,019	75,181	11,778
Investment Tax Credits	(20,019)	--	30,934	--
AFUDC - Equity Portion	(118,353)	(205,441)	(130,123)	(104,146)
AFUDC - Interest Portion	(123,797)	(79,400)	(91,332)	(33,201)
Other	--	14,344	--	--
Total Non-cash Items	(80,097)	(142,063)	(33,026)	(104,553)
Cash Provided from Operations	267,667	222,911	222,821	47,105
Net Interest Expense	261,988	148,796	60,465	58,570
Cash Provided from Operations Before Interest Expense	$529,655	$371,707	$283,286	$105,675

*AFUDC = Allowance for funds used during construction.

[a]This analysis may not accurately predict future coverage ratios in cases where the rate of return; revenues or interest expense has changed significantly from the previous year's total. For example, Lilco drew down most of its bank lines in the last quarter of 1983 thereby significantly increasing its interest expense for the future. This increased interest cost is not reflected in the 1983 interest expense.

[b]Earnings before interest and taxes divided by gross interest expense including that portion of interest expense allocated to AFUDC. Earnings exclude the equity portion of AFUDC, which is a non-cash item.

[c]Earnings before interest and taxes divided by gross interest expense including that portion of interest expense allocated to AFUDC. Earnings include the equity portion of AFUDC, which is a non-cash item.

[d]Cash provided from operations before interest expense divided by gross interest expense.

Office of State and Local Finance
U.S. Department of Treasury
April 30, 1984

DEPARTMENT OF THE TREASURY
OFFICE OF THE GENERAL COUNSEL
WASHINGTON, D.C. 20220

Attachment C

LEGAL QUESTIONS PRESENTED BY A UTILITY BANKRUPTCY

Introduction

Anticipating and cataloguing all of the potential issues and problems that would be faced in a utility bankruptcy is complicated by two major factors: (1) the lack of any experience with utility bankruptcies (there has not been a reorganization proceeding of a major operating electric company or gas utility since the depression); and (2) the significant changes in bankruptcy law that took place in 1978 with the adoption of the Bankruptcy Code. Thus any discussion must be caveated with the disclaimer that almost all of the issues and questions discussed below present questions of first impression and therefore there are few, if any, certain answers to these questions. Furthermore, any such utility bankruptcy likely will generate issues and questions not listed here. Nevertheless, the problems faced by General Public Utilities (GPU) in the wake of Three Mile Island provide some insights. Furthermore, the current problems of Public Service of New Hampshire, Lilco and Public Service of Indiana have generated some initial legal work which sheds

some light on these questions. The following is a summary discussion of the questions generated by a utility bankruptcy.

Initial Cash Flow

The initial question that would be faced in a utility bankruptcy is what effect the filing of a bankruptcy petition would have on providing services. In the short run the utilities' cash flow position should be improved. The utility could cease all construction work on pending plants, suspend dividend payments (common and preferred) and interest payments on unsecured and secured debt. Furthermore, utilities commonly have a stockpile of fuel and supplies that could mitigate immediate purchase requirements. Finally, if the utility is a member of a power pool (and assuming the power pool is a utility within the meaning of the Bankruptcy Code), the power pool would be required to continue to sell electricity on the usual terms for a period of 20 days following the commencement of the case. Thus, commencing a case in bankruptcy should not be expected to result in the immediate failure to provide electricity.

While there are some initial potential cash flow benefits, there will be some additional costs that will partially offset these benefits. Trade and power supply credit could be more costly as normal financing is no longer available. Creditors could be expected to demand either

immediate cash payment or the posting of bonds. The experience of GPU is instructive in this regard. After the Three Mile Island accident GPU sought to negotiate power supply agreements with other utilities. They obtained the needed supply but in some cases were required to pay for purchases in advance and in other cases were required to pay weekly. One would expect that a utility in bankruptcy would experience at least comparable payment demands from its suppliers. Furthermore, with respect to a power pool of which it is a member, after the initial 20 day period, a debtor utility would be obligated to furnish "adequate assurance of payment ... for service." In addition, with a complicated bankruptcy case, interim payments to court appointed officials could be substantial and frequent (perhaps monthly). Furthermore, previously obtained bank lines of credit will be unavailable without the lender's consent. In spite of these problems, and depending on the facts of each case, improved cash flow might well make meeting operating requirements possible.

After the initial shock of the filing for bankruptcy, a veritable host of questions will arise. The following is an overview of the major question areas.

Operational Questions During Bankruptcy

While in bankruptcy, and indeed even before a bankruptcy is filed, a utility should be expected to experience a series of operational problems. For example,

retaining key employees may be difficult -- particularly when they realize that their claims for wages, commissions, vacation, severance and sick leave pay entitled to priority cannot exceed $2,000. This could pose problems both in the maintenance of service and facilities and, as explained below, in retaining NRC construction permits and operating licenses. In addition, meeting the unique financing problems of a debtor in possession will require sophisticated employees -- employees that might be difficult to attract. Furthermore, at least some aspects of service may deteriorate over time if regular maintenance is deferred or not performed. Thus while electricity will still be produced, more frequent interruptions may well be expected and responses to outages slower than customers have become accustomed to.

Capital Structure Questions During Bankruptcy

The questions relating to the capital structure of the utility at the time a bankruptcy petition is filed and the raising of new capital thereafter is complex. As previously noted, dividend payments on equity and interest payments on debt are suspended in bankruptcy. Existing secured debt poses different concerns. In most investment-owned utilities secured debt (in the form of first mortgage bonds) is secured by a first lien on all of the utilities assets. Two points with respect to the secured debt should be noted. First, the lien may well extend to accounts receivable and revenues. The validity of the security interest in these items is open to

substantial question and would, in any event, likely be litigated. If the secured creditors' interest in these items was upheld, the secured creditors could be expected to argue that their rights should be protected -- and this in turn could limit the flexibility of the debtor utility in attempting to conduct its business. Second is the question of penalty interest. The indenture may provide that in an event of default (with bankruptcy included as an event of default) interest on all secured debt would bear interest at the highest interest rate due under any secured indebtedness. The Bankruptcy Court should be expected to cast a jaundiced eye on claims for penalty interest. It is not clear however, that the Bankruptcy Court successfully could refuse to enforce such a claim. If effective, this provision would result in significantly increased costs as older, lower interest debt is stepped up. To the extent such interest is allowed and there is an equity cushion (i.e. the value of the estate exceeds the principal and nonpenalty interest on secured debt), penalty interest could consume more of the estate penalizing unsecured creditors and equity holders and could make it difficult to attract additional capital.

The Bankruptcy Code contains provisions designed to enable a debtor in possession to obtain needed capital. First, under Section 364(a), the debtor in possession may borrow unsecured funds for the purpose of continuing the

business in the ordinary course and, under Section 364(b) and with court permission, for other purposes. The prospects of obtaining significant unsecured credit is unlikely. For instance, even though not in bankruptcy, the GPU companies, after Three Mile Island, were required by their bank lenders to secure their borrowings.

If unable to obtain unsecured credit, Section 364(c) of the Bankruptcy Code authorizes the court to permit borrowings that can be secured by either a lien on property that is not otherwise encumbered or by a junior lien on property that is subject to a lien. Most utilities, however, have very little unsecured property. Thus the right to grant secured status on unsecured property is unlikely to provide significant capital infusions. Furthermore, the willingness of creditors to lend on a junior lien basis is unknown but questionable.

Finally, Section 364(d) provides that the court may authorize the reorganization estate to borrow on the basis of a lien that is senior or equal to the existing lien on the property. This could be done, however, only if the debtor in possession is unable to obtain credit elsewhere and there is adequate protection of the existing lien holder's interest. The reorganization estate has the burden of proof on the issue of adequate protection. The existing lienholder should be expected to contest any effort to grant new creditors security that would jeopardize its position. Unless there is an equity

cushion (i.e. the value of the reorganized estate is greater than the existing secured claims), it would be difficult for a court to find that there is adequate protection. Absent such a finding, lien priority could not be granted. On the other hand, a Bankruptcy Court could find the needed equity cushion by valuing the estate generously.

Based on the foregoing it appears that the only way to attract significant amounts of additional capital could well be through the provisions of Section 364(d) and that the greater the amount of capital necessary, the harder it will be to demonstrate that the existing lien holder has adequate protection. Given utilities' traditional high capital requirements, attracting new capital should be expected to pose very significant problems for a debtor utility. On the other hand, on a case by case basis, and if there were some prospect of recovering some of their unsecured investment, creditors might be willing to provide additional capital. A debtor utility thus might have some leverage over its unsecured creditors.

Nuclear Regulatory Commission (NRC) and Other Regulatory Questions

The utilities that currently face the prospect of bankruptcy are involved in the construction of nuclear power plants. A bankruptcy for a utility with nuclear power plants

under construction and/or in operation raises an additional level of complexity by introducing another regulator -- the NRC. Numerous questions in this area can only be posed and not answered. For example, what would be the interaction (and powers vis-a-vis each other) of the Bankruptcy Court and the NRC? For a bankrupt utility with an operating plant (and an NRC operating license) a strong argument can be made that the act of declaring bankruptcy should not trigger an NRC suspension or termination of an operating license. On the other hand, factors related to bankruptcy (i.e. loss of key personnel or ability to perform maintenance) can raise health and safety issues that could lead to NRC action. In addition, dismissal of current management and appointment of a trustee could be viewed as a change of ownership requiring NRC approval. In that event the issue would be the ability of the new owner to operate a nuclear power plant. Finally a bankruptcy might cause the NRC to question whether the utility could meet its decommissioning and clean up obligations. One would expect that since an operating plant is a revenue producing asset that the Bankruptcy Court as well as the debtor utility in possession would take every possible step to preserve the value of the asset.

The question of a plant under construction is even more problematical. It may be that the preferred course of action is to terminate the project and eliminate the cash drain the

project has produced. In that event termination of the NRC construction permit would not be a major problem -- at least to the debtor utility. If, however, it were determined that completing or selling the plant was desirable in order to preserve the value of the estate, entering bankruptcy would prompt NRC review of the construction permit and the ability of the utility to complete the plant. In addition, intervenors opposed to the plant should be expected to claim that the bankruptcy should lead to termination of the construction permit. Furthermore, since construction and operation of a nuclear power plant is subject to NRC regulation, attempts to sell the asset would encounter difficulties -- even if there were a willing buyer.

On the other hand, it is possible that a utility could receive some protection from regulatory requirements on its existing power plants. Last month, the United States Supreme Court agreed to review a Sixth Circuit decision (In Re Kovacs) which concluded that Ohio could not enforce an order it had obtained in state court requiring removal of hazardous waste from a dump site by a person in bankruptcy. (The United States has filed an amicus brief in support of Ohio's position that the order should be enforced.) While it is impossible to predict how the Supreme Court will decide the issue or the effect of any such decision, it does suggest that numerous complex regulatory issues will be contested and litigated in any utility bankruptcy.

Insurance Questions

Two major insurance questions are likely to arise in a utility bankruptcy. The first question is whether insurance proceeds can be used by a utility debtor in possession for purposes other than the payment of indebtedness. Most electric utility indentures provide that insurance recoveries be paid to the indenture trustee with withdrawals permitted for repairs or against property additions if there has been no default. After a default withdrawals are permitted if the indenture trustee determines in his discretion that the withdrawal will not affect the interests of bondholders. If there was an insured loss after bankruptcy, there could be a contest between the secured creditors and the debtor in possession as to the use of such proceeds. Even if, as is likely, a Bankruptcy Court would permit the proceeds to be used to repair the damaged facility, there could be a delay in performing such work and restrictions imposed on how the work is done.

The second question concerns nuclear insurance. Such policies provide for retroactive premium assessments. Thus, insurers are concerned with the financial health of the insured utility. While an insurer would probably be prevented from terminating such insurance, there does not seem to be any way an insurer could be forced to provide new coverage. Thus, a debtor utility may be unable to obtain insurance to operate

a nuclear power plant and, without insurance, be unable to obtain NRC licensure.

Confirming a Plan

Almost everyone who has studied the problems of a utility bankruptcy concurs that one of the most difficult problems that will arise will be the required interaction between the Bankruptcy Court and the public utility commission. The Bankruptcy Code specifically prohibits the Bankruptcy Court from interfering with the rate-making process and makes the confirmation of any reorganization plan conditional upon the approval of any proposed rate change by the ratemaker(s). Thus the Bankruptcy Court may impute a new rate based upon the utility's new balance sheet and use that new imputed rate to calculate the feasibility of the plan. The ratemaker, in its independent judgment, could set a different rate than the one imputed -- thereby making a feasibility determination impossible. The problem is exacerbated when there is more than one ratemaker. In addition, many of the traditional ratemaking analyses may be subject to question. For example interest and income tax expenses are major elements in the ratemaker's traditional revenue requirement determinations. In bankruptcy the utility would be in a tax loss position and would not be paying, but would be accruing, interest on its debt. Furthermore, ratemakers traditionally provide for senior capital costs on the basis of embedded capital costs as

it exists at the time of the rate determination. As noted above, however, senior capital costs may be dramatically increased as a result of penalty interest. More fundamentally all historical capital cost determinations might well be irrelevant in a reorganization context. The questionable relevance of these traditional ratemaking analyses suggest that it is unclear what basis the ratemaker would adopt in order to set rates.

Ripple Effects

While the ripple effects of a utility bankruptcy could be very extensive, two such effects come immediately to mind. °First is the question of the effect of a bankruptcy on co-tenants in either a plant under construction or operation. If a debtor utility decided to abandon a project the cotenants would have to fend for themselves. Their claims against the debtor utility would be unsecured. They would have to complete the project themselves either by coming up with additional funding or finding a new partner. Even if they could obtain the means to complete the project, they likely would need NRC approval and such approval could be time consuming. As experience has shown, delay is quite costly in the construction of nuclear power plants. With these uncertainties completion of the project might well be impossible and, depending on their individual financial positions, the involved utility cotenants could face bankruptcy themselves.

Second, the results of a Bankruptcy Court writing down assets to fair market value and abandoning burdensome assets could produce some losses for the secured creditors and substantial or complete losses for unsecured creditors and equity holders. Utility investments historically have been considered safe and therefore have been favored investments of pension funds, insurance companies and investors expecting and needing a steady stream of earnings. Losses therefore could produce some economic suffering. The Washington Public Power Supply System ("WPPSS") experience suggests that such investors will be quite active in seeking governmental redress for their losses. It is unclear, however, whether even organized investors will be able to generate support for federal action.

Municipal Utility Bankruptcy

As the result of the suspension or termination of construction on nuclear power plants, municipal utilities may face financial problems or bankruptcy. Unlike investor-owned utilities and cooperatives, municipal utilities cannot file for bankruptcy under chapter 7 or 11. The major distinction between a chapter 9 and chapter 11 bankruptcy centers on the governmental nature of a municipality. Thus a municipality can not be forced into bankruptcy and any reorganization plan must be consistent with state law. Furthermore, since municipalities use revenue bonds as a major form of financing,

certain provisions of the Bankruptcy Code may produce problems related to that form of financing. Specifically, revenues received 90 days prior to bankruptcy may be subject to the Code's voidable preference provisions and revenues generated after bankruptcy may not be subject to the lien of the after acquired property clause of the revenue bond.

Summary

As noted initially, cataloguing issues associated with a utility bankruptcy is by necessity an exercise in speculation. The legal questions and uncertainties are substantial, real and ultimately unpredictable. It is possible that the more substantial and frightening the legal uncertainties become the more the current participants in these problems will compromise and work for solutions that avoid the above catalogue of horribles. At this time, the most a legal analysis can do is predict that any utility bankruptcy likely will be lengthy, costly and fiercely litigated.

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MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: The Working Group on Federal Credit Policy (Ballentine)

SUBJECT: Expansion of the Secondary Market for SBA-Guaranteed Loans

The Small Business Administration (SBA) provides credit in the form of direct loans and guaranteed loans to small business. Both the House and Senate Small Business Committees are considering legislation, H.R. 4773 and S. 2375, that would expand the secondary market for SBA-guaranteed loans. There is bipartisan support for both bills and early action is anticipated. SBA been scheduled to testify in support of this or similar legislation; however, SBA declined to testify because of differences with OMB, CEA and Treasury over the appropriate position on the legislaton. No Administration witnesses have testified on H.R. 4773 or S. 2375, nor have reports on these bills been sent.

Background

Proponents of the SBA loan guarantee program argue that such a program is necessary to provide long-term credit to small business. However, the extent to which small business has difficulty in obtaining long-term credit is not clear. A 1983 GAO survey of banks participating in the SBA program (about 60% of all commercial banks) found that 30% to 40% of all their long-term loans to small business carry an SBA guarantee. Another survey indicates that small businesses, particularly start-up companies, have difficulty in obtaining financing (typically one-third of SBA borrowers are start-up firms). Conversely, studies conducted by both private trade associates and Federal bank regulatory authorities have not found significant evidence that a small business has trouble obtaining financing. The vast majority of small businesses obtain financing without Federal assistance (less than 1% of small businesses receive SBA assistance; less than 50% of all small businesses ever apply for a bank loan).

It is difficult to generalize about the types of businesses assisted by SBA guaranteed loans; restaurants and bars were the largest recipients of loans in 1982, receiving almost 8% of the total. Car dealers, automobile service firms and medical professionals also were large beneficiaries. Nearly half of the credit is extended to wholesalers and retailers; a high percentage of recipients are repeat customers who received guaranteed loans in the past.

Over 90% of SBA credit assistance is provided through guaranteed loans. The Administration has proposed to eliminate SBA direct loans beginning in 1985. Further, the Administration has also proposed that guaranteed loans, which have risen 700% from $0.5 billion in the late 1960's to to $3.8 billion last year, be phased down to approximately $1 billion by 1988.

These Administration proposals, included in the last three budgets, are based on several rationales: it is not clear how effective assistance has been in increasing the viability of small business (the default rate in the guaranteed loan program is approximately 20%); most businesses obtain financing without SBA credit; the improved economic climate reduces the need for targeted subsidies.

SBA claims that the willingness of Congress to reduce SBA direct loans is predicated on Administration support for guaranteed loans, including an improved secondary market. OMB believes that Congressional action on SBA direct loans is not linked to support of H.R. 4773 and S. 2375. The Senate has been and is expected to continue to be supportive of Administration policy on direct loans; the House is expected to oppose it.

The Current Secondary Market

Under current law, the SBA can guarantee 70% to 90% of the value of an approved loan. In practice, most loans are guaranteed for 90% of their value (a Congressionally mandated requirement for loans under $100,000) including all interest on the guaranteed portion. Lenders are permitted to sell the guaranteed portion of an SBA loan to third-party investors. Thirty-seven broker/dealers currently make a secondary market in SBA-guaranteed loans. SBA estimates that approximately 20%, or $400 million, of the annual volume of guaranteed loans that qualify for the secondary market is sold annually in the secondary market. Although the small size of this secondary market may result from the perceived nature of the SBA guarantee, the GAO has suggested that administrative errors and delays have kept investors away from the program.

SBA has sought to expand and improve the operation of this secondary market; however, SBA believes that certain problems with the current program, discussed below, need to be remedied through legislation.

- SBA believes that the marketability of guaranteed loans is impaired because of doubts as to the transferability of the SBA guarantee to third-party investors. These doubts arise because the existing authorizing legislation does not explicitly state that SBA guarantees are backed by the "full faith and credit" of the United States. Though the Attorney General and the SBA General Counsel have issued legal opinions holding that an SBA guarantee pledges the full faith and credit of the United States, this is apparently insufficient assurance for some investors.

- The current SBA guarantee does not provide for timely payment of principal and interest; thus investors can face delays of several months in obtaining full payment in cases of default.

- SBA can refuse to honor loan guarantees in cases where fraud or negligence is involved. In practice, SBA honors the guarantees on loans sold in the secondary market and seeks recovery against the fraudulent/negligent originating bank. However, SBA discretion with respect to such guarantees creates uncertainty for secondary market participants.

- SBA does not have explicit statutory authority to promote, standardize, or broker transactions in the secondary market.

Proposed Legislation

H.R. 4773 and S. 2375 would address these issues as follows:

- The "full faith and credit" of the United States would be explicitly pledged behind the guarantee.

- A guarantee of timely payment of principal and interest would be added to the existing guarantee.

- SBA would be given a Congressional mandate to promote secondary market activity, pool guaranteed loans, and act as a broker.

These changes, in particular the creation of a guarantee of timeliness, will increase the attractiveness of SBA-guaranteed loans by lowering interest rates and will expand demand for this subsidized credit. However, expanding the guaranteed loan program runs counter to the Administration's budget and credit policies. If the CCEA concludes that additional credit is needed in the small business sector, two alternative methods of reaching this goal should be considered.

1) The Federal Financing Bank Alternative

The guaranteed portion of SBA-guaranteed loans could be sold to the Federal Financing Bank (FFB) rather than sold in the secondary market. This converts the guaranteed loans into direct loans and increases Federal borrowing.

Treasury argues that agency securities 100% guaranteed by the full faith and credit of the United States are equivalent to Treasury securities. However, the interest rates on agency securities sold in the secondary market are generally 50 to 100 basis points higher than those available on direct Treasury issues. Financing the SBA guaranteed obligations through the FFB would avoid this differential.

However, under existing FFB procedures the 50 to 100 basis points cost savings is passed on to the underlying borrower. Consequently, use of the FFB results in an additional subsidy. In the SBA case that additional subsidy will increase the attractiveness of the program to borrowers and create pressures for expansion.

The cost savings need not be passed on to the borrower. In principle, the FFB could raise interest rates on guaranteed loans that it converts into direct loans by an amount that approximately offsets the additional saving that arises through FFB financing. This is not done now, however, and would be controversial.

2) Private Sector Deregulation Efforts

It may be possible to improve small business access to credit by removing legal barriers that prevent most banks from insuring a pool of commercial loans and issuing securities collateralized by such loans. Under current law, commercial banks cannot insure loans, nor issue securities backed by commercial loans. Both the Garn bill and the Financial Institutions Deregulation Act (FIDA) allow insurance activities for banks. However, these bills would not permit the issuance of securities that would make the development of a totally private secondary market possible.

The feasibility of a private secondary market that operates with banks -- not the government -- guaranteeing small business loans is indicated by the success of one bank in handling such a transaction. A set of unusual quirks in the applicable bank regulations allowed the sale of a pool of privately guaranteed small business loans. Absent further deregulation efforts, which are not currently anticipated, this type of transaction is not likely to be repeated. If legal barriers to such transactions can be removed, however, credit flows to small business could be increased without any Federal guarantee, subsidy or intermediation.

Options

1) Oppose H.R. 4773 and S. 2375.

- o The Administration is committed to reducing the level of SBA-guaranteed loans substantially over the next three years. Providing SBA loans with a new guarantee of timeliness of payment would create a new GNMA-type security. Such an expansion of Federal guarantees violates the Administration's credit policies.

- o There is no assurance that expanded loan guarantees will induce the House to support a reduction in direct loans.

- o Limiting the use of GNMA-like instruments as collateral for SBA loan certificates increases the likelihood of success in fostering a private secondary market through deregulation. Conversely, encouraging SBA broker activity will damage existing private brokering activity.

2) Support H.R. 4773 and S. 2375.

- o Support of this legislation would lower the cost of SBA-guaranteed loans.

- o Using new Federal loan guarantees to increase private sector interest and participation in the secondary market represents the level of Federal/private partnership SBA would like to encourage.

- o Congress is more likely to eliminate direct loans if the Administration does not reduce guarantees and indicates that direct loan demand can be handled through the guarantee program.

- o These bills would channel private capital to the small business community and would diminish the cyclical nature of the banking community's ability to provide capital.

3) Support the legislation, amended to require that loans be sold to the FFB and that a charge be made for the additional FFB subsidy.

- o Support of this legislation would lower the cost of SBA-guaranteed loans.

- o It would be more efficient to sell loans to the FFB rather than selling them in the private secondary market.

- o If the FFB charges for the additional subsidy, the enhanced small business subsidy will be limited to that provided by the bill as is.

- o However, if, as under existing practice, the FFB does not charge for the cost savings, the total level of subsidy and volume of loan activity will be greater than under the secondary market proposal.